

# The Future of Financial regulation and Emerging Markets

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In the last 24 months we have been shocked by a path breaking crisis. Several pre established thoughts and ideas have been challenged by reality.

It is now common sense to say that emerging markets are no longer what they used to be. They now constitute the primary driver for economic growth and have become major players in financial markets. While this has been recognized with the constitution of the G20 and the Financial Stability Board, the complexity and heterogeneity of emerging markets and economies will still require

some more effort in terms of inclusion of various jurisdictions to the international financial and economic debate. IOSCO is once again in the forefront of that effort with its new strategic direction.

But the crisis has not only shifted power to emerging markets, it has also challenged thoughts and ideas about how individuals, markets and the economy work. Fully assessing this is one of the most difficult and challenging efforts of this time for having a regulation that promote safer financial markets without hampering socially useful innovation.

Risks in financial markets have shown to be less evident than what we thought. Risk transfer mechanisms we thought we understood work only imperfectly and the aggregation of individual risks is an extremely tricky task.

Indeed, risks of particular instruments, risks in particular markets and systemic risk, are much closer than what we thought. And that means that

securities regulators need to review their role with financial stability and systemic risk as background. This, of course, does not mean that we should compete with Central Banks or prudential regulators. The lesson we need to take out of this exercise is that financial markets workings, its regulations or the market segment we do not regulate, its supervision, the products that are designed and distributed, the products that are not regulated, the way financial products are traded, the expectations investors have, the information disclosed that affect such process of expectations creation, all of this have far from obvious systemic risk implications. Beyond conventional policy tools such as interest rate changes, Central Banks have shown to be available for using various types of unconventional policy tools when facing extreme circumstances. Those unconventional policy tools remain either in universe of money supply management, such as

*quantitative easing*, or in the banking regulation, *such as risk based capital requirements*.

But as financial markets also show their capacity to destabilize an economy, we found ourselves with limited policy instruments available. In part this is due to the fact that for most financial regulators financial stability and systemic risk was not perceived to be under their remit. But it is.

Therefore we need to find policy instruments beyond the conventional limits of traditional financial regulation. The crisis illustrates we need *unconventional* policy tools but we have no clear views of which those instruments are, when and how should they be applied. We eventually know that markets are often driven by *animal spirits*, by irrational exuberance, and while sometimes that can be due to factors external to markets, such as a too expansionary monetary policy, we have learnt in recent years that human rationality assumptions embedded in neoclassical economic theory is largely

to strict. We need an exercise of humility and recognize various limitations to individual's rationality, as it has been discussed by the growing behavioural finance literature.

Now, markets can be driven by individuals, such as aggressive CEO's or successful traders, but more often are markets driven by corporations of different sizes and natures. Therefore, our discussions and considerations of rationality should not be bound to individuals but to corporations, how do they process information, how do they take decisions, which balance of power do they have. In short, we need to review our thoughts on *corporate governance*.

Indeed, to some extent one can say that this crisis was the outcome of massive corporate governance failure: credit rating agencies and audit firms that did not manage well conflicts of interests, institutional investors that invested in instruments they did not well understand.

I would like to add to this list that we need to take proper care of the governance of regulatory bodies themselves. Let me refer to this point briefly. During the nineties, several countries around the globe made important reforms to improve the institutional status of Central Banks, in particular given them some more autonomy with respect to the political cycle. In the case of financial regulation the very important discussion so far is devoted to architecture and perimeter but not so much on governance and autonomy. I believe we need more autonomy from the political cycle, matched with increased accountability and sound political representation, but also better conditions to deal with from regulated industries themselves.

We would make a mistake if we believe that ideology or political pressures will not be around our work in the future as they have been in the past. The challenge is to make ideology and political pressures as transparent as possible and as accountable as

feasible. And the same applies to industrial pressures. I hope that the next couple of years we shall see a significant strengthening on the conditions under which the regulatory activity is developed.

Finally, what we thought were conventional good practices have been challenged by the crisis as well. In the Emerging Markets Committee we have been working in the last two years in trying to identify best practices in key markets. I would like to stress two works done by EMC task forces.

One concerns OTC markets. This task force was chaired by Turkey and discussed all relevant issues concerning OTC markets in the context of jurisdictions belonging to the EMC. And, eventually not surprisingly, the report finds that good practices concerning issues such as standardization of OTC products, registration of OTC products and on exchange trading, all issues that are at the centre of the discussion in the international arena. This report

was approved for publication and will be sent as a contribution to the Financial Stability Board.

The second report concerns securitization. I am personally convinced about the convenience of securitization. The task force, co chaired by India and Mexico and with the technical support of the IMF, while not ready yet, has found very interesting results such as that in EM jurisdictions retention practices are common in 70% of the surveyed countries. This means that the alignment of interests of originators was better.

While it may be true that eventually some of this regulations and practices in emerging markets may have prevented those markets to grow as spectacularly as in some developed jurisdictions, nothing says that the size of those markets was the optimal from the social point of view.

Fellow regulators, the crisis started in developed markets and spread to our markets by various channels. It appears as if it receded, but there are



risks ahead, we better have our eyes wide open and continue hard working making our regulations better and better.